High Quality Diversification Benefits of Asia Credit

Strong fundamentals and powerful tailwinds make this growing asset class one to watch for global investors.

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KEY INSIGHTS

- Asset class offers an increasingly significant opportunity set, growing to nearly USD $1 trillion in issuance as a vast regional investor base absorbs new supply with resilient spread performance.
- Improved leverage profiles and low historical default rates support Asia credit fundamentals, while direct access to region with high economic and demographic growth provides powerful tailwind.
- Asia credit has delivered diversification benefits and defensive qualities similar to developed credit markets (DM) along with an attractive risk-return profile versus major asset classes.

Asia credit reaffirmed its case in 2018 as an asset class that could potentially offer both upside potential and defensive qualities. In a year when significant drawdowns hit nearly every asset class across fixed income, equities and commodities, Asia credit stood apart having only experienced a marginal decline. So far in 2019, it has delivered 9.1%, largely on the back of price appreciation.[1] With a yield profile of about 3.9%, the asset class also offers income opportunities at a time when nearly a quarter of global bonds have a negative nominal yield.[2]

The strong recent performance has come in spite of prominent negative headlines regarding China's slowing economic growth and its potential impact on the region. Such concern may partly be attributed to an unfamiliarity with idiosyncratic markets across the region like China, India and Indonesia. Media coverage of the contentious U.S.-China trade war has also increased scrutiny on whether financial markets in Asia are vulnerable to external pressures. Taken together, this has created an unfounded perception that the asset class carries undue risk.

Investors should certainly remain vigilant in monitoring future developments within the market, but they would also be well served to consider objectively how Asia credit could potentially contribute as a portfolio component. A close examination of the asset class reveals that many of the factors which have contributed to its performance remain intact.

Asset Class Continues to Grow

The Asia credit market grew more than four-fold over the past decade to USD $980 billion in outstanding debt in the second quarter as Asian corporations increasingly utilized

[1] J.P. Morgan Credit Index Diversified, data as of July 31, 2019.
[2] J.P. Morgan Credit Index Diversified, yield to worst data as of July 31, 2019; Bloomberg Barclays Global Aggregate Bond Index, data as of July 12, 2019.

> Currently, less than one in 50 listed Asia ex-Japan companies has an outstanding foreign currency bond.

capital markets to fund growth plans. The region has accounted for more than 50% of emerging markets (EM) bond issuance each year dating back to 2014.[3]

The J.P. Morgan Asia Credit Index Diversified is a USD-only benchmark that balances exposure across the Asia ex-Japan region to reduce concentration risk in any single market. It includes a cross-section of developed markets, like Hong Kong and Singapore, as well as both EM and frontier markets. Overall, the benchmark has a diversified investment grade profile with 77% of its bonds rated as investment grade (IG) and an average credit rating of BBB+, as of July 31, 2019.

Structural Demand for Asia Credit

In terms of demand, we believe the appetite for new issuances should remain buoyant in the current environment given relatively attractive valuations combined with higher-yielding opportunities. Moreover, the high savings rate in Asia versus other regions creates a powerful structural demand from within the region for income-generating investments, reducing Asian companies' reliance on external capital. Local investors accounted for 88% of corporate debt ownership in Asia, unlike EM more broadly where foreign investors have a larger share.[4]

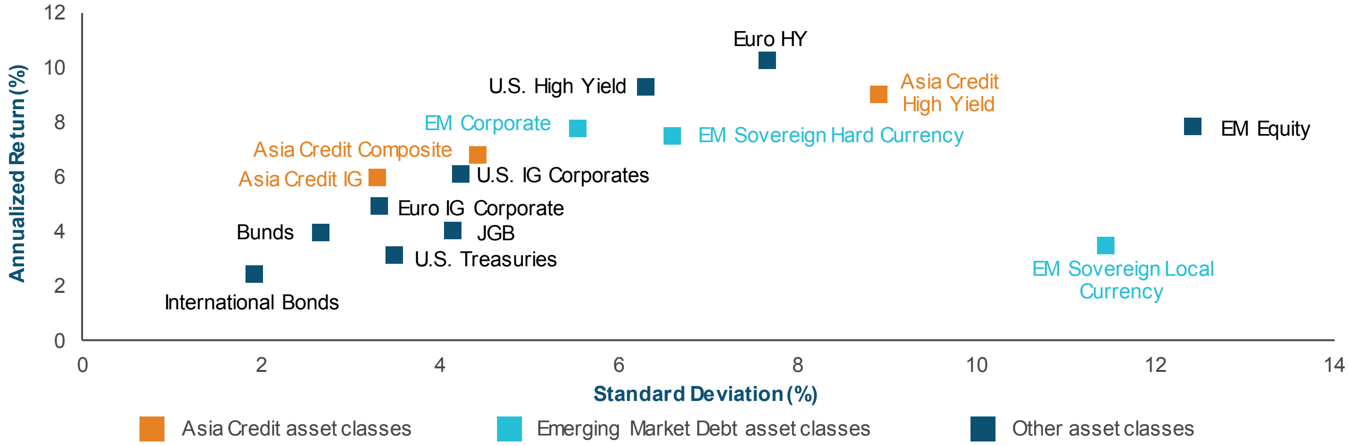
Since 2010, the Asia credit asset class has grown by an average of 15% per year, unlike the stable-to-shrinking U.S. high yield and EM sovereign debt markets.[5] We expect further growth in the near term as more Asian corporates look to tap the market and take advantage of favorable liquidity conditions in the current low-interest rate environment. Currently, less than one in 50 listed Asia ex-Japan companies has an outstanding foreign currency bond.[6]

There could be a slowdown in Chinese dollar bond issuance, however, given that onshore liquidity improved in 2018 as China pared back recent deleveraging efforts in a bid to

(Fig. 1) Delivering Strong and Steady Returns

Asia credit compares favorably over a 10-year period

As of June 30, 2019



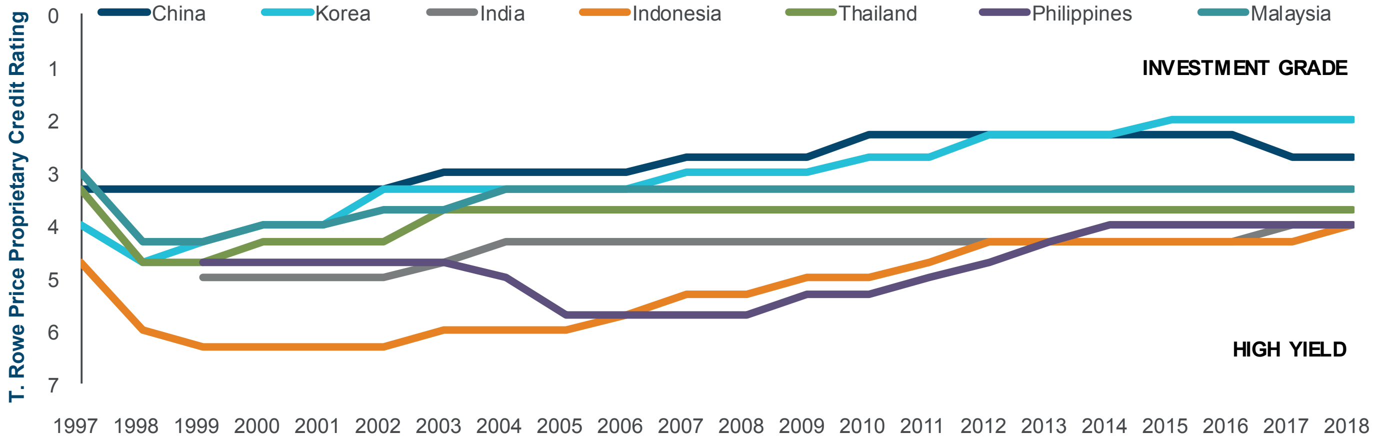
Past performance is not a reliable indicator of future performance.
International bonds: BBgBarc Global Aggregate Treasuries Index, U.S. Treasuries: BBgBarc U.S. Treasury Index; U.S. IG Corporate: BBgBarc U.S. IG Corp. I.G. Index; U.S. High Yield: BBgBarc U.S. High Yield; EM Sovereign Hard Currency: J.P. Morgan Emerging Market Global Diversified Bond Index; EM Corporates: J.P. Morgan CEMBI Broad Diversified; EM Sovereign Local Currency: J.P. Morgan GBI EM GD Index; Euro IG Corporate: Euro Aggregate; Euro Corp I.G. Corporates Index; Euro HY: BBgBarc Pan-European High Yield; JGB: BBgBarc Asian Pacific Japan; Bunds: BBgBarc Global Treasury Germany; Asia Credit Composite: J.P. Morgan Asia Credit Index Diversified; Asia Credit IG: J.P. Morgan Asia Credit Index Diversified IG; Asia Credit High Yield: J.P. Morgan Asia Credit Index Diversified HY; EM Equity: MSCI Emerging Markets. This chart is shown for illustrative purposes only and does not represent the performance of any specific security, product or service. It is not possible to invest in an index. Source: Bloomberg Barclays, J.P. Morgan, MSCI, T. Rowe Price.

[3] J.P. Morgan, Bond Radar, data analysis by T. Rowe Price, data as of June 30, 2019.
[4] J.P. Morgan data, debt outstanding as of October 31, 2018.
[5] J.P. Morgan Credit Index, data as of June 30, 2019.
[6] J.P. Morgan research

(Fig. 2) Top Down Fundamentals Getting Stronger

Key Asian economies continue to improve credit ratings

As of June 30, 2019



For illustrative purposes only.

Sources: Rating Migration data analysis by T. Rowe Price using Moody's data as of 06/30/2019. Local Currency

T. Rowe Price proprietary rating scale ranges from 1 to 10, with 10 being the equivalent of a defaulted security and 1 being the equivalent of a AAA-rated security, as defined by the major ratings agencies.

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stimulate the stalling economy. In 2019, several China property developers have tapped offshore markets multiple times already, however, and durations are extending longer, which provides a more consistent risk profile for the asset class.

Strong Top Down Fundamentals

Robust economic growth in Asia ex-Japan has provided a powerful tailwind for the region's corporates to capitalize on new markets both at home and abroad.

In the span of just a decade, China eclipsed Japan as the world's second-largest economy and is now more than double its size. The entire region accounts for 27% of the global economy, up from 10% in 2000. Robust growth has also sparked a rising tide of wealth across emerging and developing Asian countries with per capita income projected to top USD $6,000 in 2020. The rise has been due in part to the region's immense population - it accounts for 2 out of every 5 people in the world - and young demographic profile in the case of countries like India, Indonesia, Bangladesh and the Philippines.[7]

We believe policymakers have taken appropriate steps to ensure continued expansion by striving to reduce reliance on export-led growth and improve openness and competitiveness of their respective financial markets. A commitment in most economies following the Asian Financial Crisis to increase foreign exchange reserves and lower inflation also bodes well. The trend of positive country rating migration seen across key regional economies reflects meaningful progress.

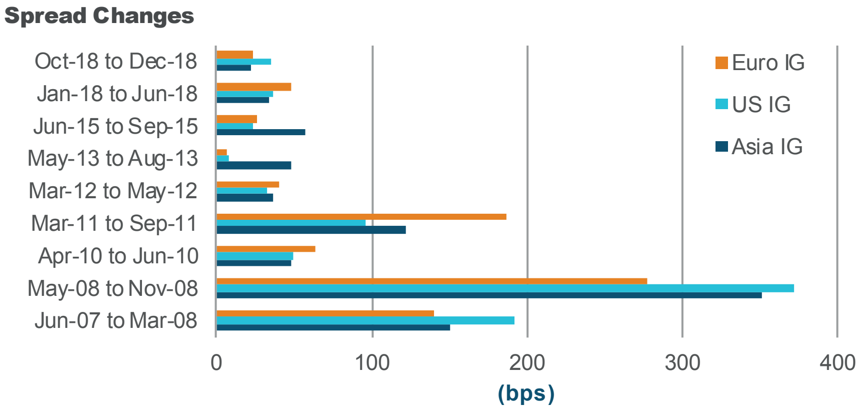
Asian corporates have demonstrated improved fundamentals in recent years. When viewed in the context of EM more broadly, Asian high yield (HY) issuers have consistently lower default rates dating back to 2002.[8] More broadly, Asian corporates have also displayed an improving leverage profile. This has not come at the expense of profitability either, as the region is forecast to deliver double-digit earnings growth in 2020.[9] Taken together, these indicators send a positive signal to fixed income investors

[7] World Bank and IMF data, data analysis by T. Rowe Price.
[8] J.P. Morgan, data analysis by T. Rowe Price.
[9] Credit Suisse valuation snapshot. As of May 27, 2019.

(Fig. 3) Providing Support for the Portfolio

Asia IG performs like developed markets during sell-offs

As of June 30, 2019



Asia IG: J.P. Morgan Asia Credit Index Diversified Investment Grade, z spread
US IG: Bloomberg Barclays U.S. Aggregate Corporate Investment Grade Index, OAS
Euro IG: Bloomberg Barclays Euro-Aggregate Index, OAS
Sources: J.P. Morgan Chase & Co. and Bloomberg Index Services Ltd.

that Asian corporates are able to grow while still improving their capacity to service outstanding debt.

High Quality Diversification

The unique characteristics of Asian corporates have contributed to Asia credit's diversification benefits, particularly for investors with large positions in core fixed income. We believe this characteristic is likely to become more permanent if the asset class continues to grow in size and scale as expected. Meanwhile, Asia credit has a relatively high correlation with Asia ex-Japan equities but a more stable return profile, allowing investors to access the region's economic development and growing markets with a lower risk profile.

While investors may turn to Asia credit in search of higher yields, a position in the asset class could also provide defensive qualities. In 2018, the resilience of Asia IG markets – which outperformed U.S. IG – helped Asia credit overall to outperform EM Corporate and EM Sovereign benchmarks. This is a pattern that we have observed repeatedly in the past 10 years, where Asia IG maintains similar defensive properties to U.S. IG and Europe IG in periods of meaningful global spread widening. There have been a few instances where Asia spreads widened relatively more, however, such as during the "taper tantrum" in 2013 when global investors pulled money out of the region in anticipation of tighter global monetary conditions. The sell-off was short-lived though as the market took stock of the region's improved top-down fundamentals.

Positive performance in Asia credit is not just a recent occurrence either. It has demonstrated an attractive risk-return profile over an extended period versus other major asset classes. It is also worth noting that Asia IG has a relatively lower duration risk than U.S. IG and Europe IG, offering higher yield on shorter-dated issuances.

As investors search for yield in the current low interest rate environment, Asia credit could potentially offer an attractive risk-return and higher yielding profile relative to other asset classes. More recently, the spread premium in Asia credit has seen volatility amid rising concern that the U.S.-China trade war could impair the region's growth prospects. In this environment, strategic investors have the opportunity to capitalize on price dislocations within the market through informed security selection as we expect the asset class will continue to grow in depth and breadth.

WHAT WE'RE WATCHING NEXT

In our view, robust economic growth throughout the region and supportive financial conditions could provide a tailwind for risk assets and Asia credit spreads. Increased uncertainty regarding the U.S.-China trade war could weigh on the asset class in the near term, however.

Over time, we expect the opportunity set within the asset class will continue to grow in both depth and breadth, favoring strategic investors who can capitalize on price dislocations within the market through informed security selection.

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